

What you need to know NOW about the bond market.



Madison's Lead Fixed Income Manager, Paul Lefurgey

We recently spoke with Madison's lead fixed-income manager Paul Lefurgey.

What's your view on the Treasury market?

We all know that Treasuries have been a great place to be over the past couple years as we've fallen deeper and deeper into this credit crisis. Investors who laddered Treasuries have had very good results. But now rates are historically low

and I believe most retail investors fail to see what could happen if rates rise. The 5-Year Treasury is around 2% and the 10-Year is under 3%. If rates normalize, as we expect, there could be a lot of people trying to sell Treasuries trying to get out the same door at the same time and we could see a very sharp change in pricing. On top of this we expect record supply as the government pays for its historic economic stimulus and bailout packages, while foreign demand, which has been a huge part of Treasury purchase over the past years, is likely to diminish. Laddered treasury strategies could do very poorly under these circumstances.

Where do you see the best bond values?

We're actively moving away from Treasuries to high-quality spread product. We see value in Treasury-backed bank bonds, also high-quality corporate bonds, and agency bonds. With the government stepping in to support the mortgage agencies we feel very good about owning their bonds. Today you can buy high-quality corporates with yields ranging from 4.5% to 6%; up to 7% in high BBB. We believe that the best results should be in a diversified portfolio with an emphasis on these spread products. At this time we are not tempted to dip down into the high-yield market or own bonds from companies with a great deal of credit risk. We still believe there is plenty of default risk. We continue to exercise selectivity and rely on our own proprietary credit research. We think there's still plenty of yield in high-quality issuance to help mitigate any rises in rates.

You mentioned preparing for a rise in rates. What is likely to make rates rise and when do you anticipate this happening?

First of all we're going to be looking at a flood of Treasury supply with at least a trillion dollar increase in federal debt. Secondly, foreign economies are slowing and commodity prices have fallen so there is less demand from historically important buyers. Thirdly, all the stimulus in the economy

should eventually take us past the current credit problems. This means a lot of new money will be flowing through the system, and as the economy picks up we'll begin to see renewed concerns over inflation. This, in turn, is likely to spark rate increases. Finally, we see a more technical issue arising from the manner in which everyone has overemphasized Treasury holdings, and when the sentiment shifts, it's going to be a difficult situation. In terms of timing, we see rates grinding upward for the rest of the year, albeit with fits and starts.

You still have a significant exposure to Financial Sector bonds. Is this a worry to you?

First of all, we are very selective with all of our corporate bond purchases. We have done a good job avoiding issuance from the firms most directly exposed to subprime loans and their associated problems. Although, of course, our current holdings are subject to market risk. We try to own the highest quality financials. One way to see the value in these companies is to look at how the government is working to prop up the financial system by adding liquidity. Anytime you reduce leverage and build up assets on a balance sheet, you have a plus for bond holders. So although we are still looking at a period of potentially painful deleveraging, we see deleveraging as a good thing for bond holders. In the end, everyone working on rebuilding the financial system recognizes that you have to get to a point where bond holders are very comfortable. If successful, this suggests tighter spreads and ultimate value for those financial companies positioned to get through this crisis.

With the housing and mortgage markets in disarray, is their any remaining appeal in mortgage-backed bonds?

We don't use mortgage-backed bonds in all of our portfolios. We do have portfolios which are managed to benchmark against an aggregate index and for these we do typically have an exposure to mortgage-backed bonds. However, we buy these bonds with a very specific objective, which differentiates us from some other managers. We buy the conventional 15- and 30-year government agency bonds. These are straight collateral products with no hidden surprises. Cash flows aren't sliced and diced, they own no subprime mortgages and have geographic diversification. The biggest risk is prepayment risk, which could occur if mortgage rates drop significantly, which we don't see happening at these current low rates. Conservative investors have historically leaned toward GNMA's, which are backed by the full faith and credit of the U.S. government. We are finding the best values in agency bonds, which do not have the same explicit backing, but due to the recent federal interventions in their businesses seem to us to offer comparable safety at this time.

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